Supreme Court, U.S.
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No. 93-823

In The

Supreme Court of the United States

October Term, 1993

STATE OF NEBRASKA, DEPARTMENT OF REVENUE,

Petitioner,

v.

JOHN LOEWENSTEIN,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Nebraska

BRIEF FOR RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a Nebraska Department of Revenue ruling which purports to allow a state tax to be imposed on income resulting from the sale of federal obligations pursuant to a repurchase agreement violates 31 U.S.C. § 3124 (1988).

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JURISDICTION

THERE IS NO CASE OR CONTROVERSY SUFFICIENT TO GIVE THIS COURT JURISDICTION.

"The exercise of judicial power under Art III of the Constitution depends on the existence of a case or controversy." *Preiser v. Newkirk*, 422 U.S. 395, 401 (1975). "The case-or-controversy doctrines state fundamental limits on federal judicial power in our system of government." *Allen v. Wright*, 468 U.S. 737, 750 (1984). The state court proceedings which petitioner seeks to challenge do not present such a "case or controversy" and therefore this Court lacks jurisdiction.

On January 26, 1985 the Nebraska State Tax Commissioner issued a nonbinding declaratory ruling, Revenue Ruling No. 22-85-1, dealing with "repurchase agreements involving obligations of the United States government."[1]

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[1] The statutory authority for such rulings is as follows:

> On petition of any interested person, any agency may issue a declaratory ruling with respect to the applicability to any person, property, or state of facts of any rule, regulation, or statute enforceable by it. A declaratory ruling, **if issued after argument and stated to be binding,** shall be binding between the agency and the petitioner on the state of facts alleged unless it is altered or set aside by a court. Such a ruling shall be subject to review in the manner provided in the Administrative Procedure Act for the review of decisions in contested cases. Each agency shall prescribe by rule and regulation the form for such petitions and the procedure for their submission, consideration, and disposition.

Neb. Rev. Stat. § 84-912 (1987) (emphasis added). There is no indication that Revenue Ruling No. 22-85-1 was "issued after

Such a ruling is simply "a written statement issued to the taxpayer that interprets and applies the tax law and regulations to a specific set of facts."[2] This advisory opinion is comparable to a revenue ruling by the United States Internal Revenue Service which "is not binding on courts, since it represents the contention of one party to a case in court and is entitled to no greater weight." M. Saltzman, *IRS Practice and Procedure* ¶ 3.03[2][b], at 3-22 (2d ed. 1991). Indeed, this Court has recognized that "these rulings have no precendential force." *Rowan Cos. v. United States*, 452 U.S. 247, 261 n.17 (1981). The ruling does nothing more than "state the policy of the Department of Revenue in response to specific factual situations submitted by taxpayers."[3] The Nebraska Department of Revenue's policy of treating the taxation of federal securities subject to a repurchase agreement is not a "case or controversy" sufficient to give this Court jurisdiction under article III of the United States Constitution.

This action did not arise from the efforts of the petitioner to collect additional tax from Loewenstein;[4] nor

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argument," nor is the Revenue Ruling expressly "stated to be binding."

[2] Revenue Ruling No. 33-76-2 (approved April 21, 1976) reprinted in CCH Nebraska Tax Reporter ¶ 18-302. Compare 26 C.F.R. § 601.201(a)(2).

[3] Department of Revenue Ruling No. 33-76-2 (approved April 21, 1976), reprinted in CCH Nebraska Tax Reporter ¶ 18-302.

[4] *See Neb. Rev. Stat.* § 77-2776 (1990) which provides that "[i]f the Tax Commissioner finds that the amount of tax shown on the return is less than the correct amount, he shall notify the taxpayer of the amount of the deficiency proposed to be assessed." Indeed, any such actions for tax years 1987, 1988, or 1989 have long since become time barred. *See Neb. Rev. Stat.* § 77-2786 (Supp. 1993) (deficiency determination must be mailed to taxpayer within three years after tax return was due).

has Loewenstein paid a disputed tax and then sought a refund.[5] Respondent's declaratory judgment action simply challenged the petitioner's announced policy with respect to repurchase agreements.[6] As such, this proceeding involves the type of "advisory opinion" that is beyond the jurisdiction of the federal courts.

> Early in its history, this Court held that it had no power to issue advisory opinions . . . and it has frequently repeated that federal courts are without power to decide questions that cannot affect the rights of litigants in the case before them. To be cognizable in a federal court, a suit "must be definite and concrete, touching the legal relations of parties having adverse legal interests. . . . It must be a real and substantial controversy admitting of specific relief through a decree of a conclusive character, as distinguished from an opinion advising what the law would be upon a hypothetical state of facts."

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[5] *See Neb. Rev. Stat.* § 77-2793 (Supp. 1993) which allows for the filing of a claim for refund or credit of any overpayment of the Nebraska income tax.

[6] Respondent did not challenge the facial constitutionality of the Nebraska income tax statute, since it provides an express exclusion for "interest or dividends received by the owner of obligations of the United States . . . exempt from state income taxes under the laws of the United States." *Neb. Rev. Stat.* § 77-2716(1)(a) (Supp. 1993). Nor did respondent challenge the statute, as applied, since no steps have ever been taken to actually collect a tax from respondent based upon the income he received from the Trusts.

North Carolina v. Rice, 404 U.S. 244, 246, (1971), quoting *Aetna Life Ins. Co. v. Harworth*, 300 U.S. 227, 240-41 (1937) (other citations omitted). In the declaratory judgment action below, the revenue ruling which the respondent sought to challenge was nothing more than "an opinion advising what the law would be upon a hypothetical state of facts." Although such a procedure is specifically authorized under Nebraska law,[7] the question of whether this Court has jurisdiction is a question of federal law. *Doremus v. Board of Educ.*, 342 U.S. 429, 434 (1952).

The constitutional requirement of a case or controversy is implicit in the requirement under the applicable jurisdictional statute, 28 U.S.C. § 1257(a), which provides that "[f]inal judgments or decrees rendered by the highest court of a State . . . may be reviewed by the Supreme Court by writ of certiorari . . . where any title, right, privilege, or immunity is specially set up or claimed under the Constitution." Since the State of Nebraska has made no specific claim against Loewenstein, no "right, privilege, or immunity [has been] specially set up or claimed under the Constitution." The state courts below have done nothing more than answer a hypothetical question. That is not sufficient to invoke this Court's jurisdiction under 28 U.S.C. § 1257(a).

The judgment and opinion of the state court below do not purport to be final adjudication on the merits of an actual controversy between the parties. They are nothing more than an abstract statement of what that court believes the law would be in a hypothetical situation.

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[7] *Neb. Rev. Stat.* § 84-911 (1987).

Until the State of Nebraska takes some specific action to attempt to collect the tax at issue, there is no case or controversy between the parties within the meaning of article III of the United States Constitution and accordingly, this Court should deny the petition for writ of certiorari because it lacks jurisdiction.

STATEMENT OF THE CASE

Respondent accepts the petitioner's Statement of the Case.

REASONS FOR DENYING THE WRIT

This Court should deny the petition for writ of certiorari for two reasons. First, there is no substantive disagreement among state high courts about the meaning of federal law which the Court must resolve. The Nebraska Supreme Court's decision was based upon a factual determination that taxation of federal obligations subject to repurchase agreements would adversely and impermissibly affect the borrowing costs of the federal government. This factual issue was not considered or discussed in the cases cited by petitioner.

Second, the decision below is entirely consistent with this Court's decision in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983) after the 1959 amendment to the predecessor to 31 U.S.C. § 3124 which did away with "formal but economically meaningless" distinctions in the area of taxation of federal obligations. The

Nebraska Revenue Ruling at issue required exempt federal obligations to be considered or taken into account in violation of 31 U.S.C. § 3124 and the United States Constitution. Therefore, there is no need for this Court to exercise its certiorari jurisdiction merely to restate well recognized federal principles.

I. THERE IS NO CONFLICT AMONG STATE HIGH COURTS ABOUT THE APPLICABLE STATUTORY AND CONSTITUTIONAL PRINCIPLES.

One of the principal purposes for certiorari jurisdiction "is to resolve conflicts among the Circuit Courts of Appeals and state courts concerning the meaning of provisions of federal law." *Braxton v. United States*, 500 U.S. 344, 347 (1991). The Nebraska Supreme Court, like all of the courts which have ruled upon cases involving federal obligations subject to repurchase agreements, recognized the fundamental principle that an "exemption applies to each form of taxation that would require the [federal] obligation, the interest on the obligation, or both, to be considered in computing a tax." 31 U.S.C. § 3124. This case is distinguishable from the cases cited by petitioner because of the Nebraska Supreme Court's **factual** determination that based upon the record before it, imposition of the Nebraska income tax would have an adverse effect on the federal government's ability to raise revenue. Given that factual determination, which was undisputed by petitioner, the decision of the Nebraska court followed as a matter of course from this Court's prior rulings.

This Court has recognized that the statutory exemption is "principally a restatement of the constitutional

rule" which prohibits the states from taxing the federal government. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). The focus of the inquiry in such a case should be on whether the proposed tax has a negative effect upon the borrowing power of the federal government. The intergovernmental tax immunity doctrine "is based on the proposition that the borrowing power is an essential aspect of the Federal Government's authority and, just as the Supremacy Clause bars the States from directly taxing federal property, it also bars the States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." *Rockford Life Ins. Co. v. Illinois Dept. of Revenue*, 482 U.S. 182, 190 (1987).[8] It is the presence of this factual determination which compelled the Nebraska Supreme Court's decision and which distinguishes that decision from cases cited by the petitioner which reached a different result.

The real test in this case is whether imposition of the Nebraska income tax will place a burden, however slight, upon federal obligations. Undisputed expert testimony makes it clear that a Nebraska income tax on federal obligations which are subject to repurchase agreements will make it more difficult and expensive for the federal government to finance the national debt and such a tax is therefore invalid. Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York (E1, 1, 2,

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[8] In *Rockford Life*, this Court's jurisdiction was mandatory under 28 U.S.C. § 1257(2). Otherwise, the Court noted, "[t]he issue presented is not the type that would usually merit our attention if presented in a petition for certiorari." 482 U.S. 184 n.3.

Tab 1, 3:9-23), testified that repurchase agreements play a substantial and important role in the market for United States government securities, and therefore are also extremely important in the process of financing the national debt. (*Id.*, 5:21-6:15).[9] Upon issuance of new government securities, the Federal Reserve distributes the securities to a limited number of "primary dealers" who then act as market-makers for the securities (*Id.*, Exhibit 1 to Sternlight Depo., ¶ 6, App. 3-4). The primary dealers, selected and approved by the Federal Reserve, then sell the federal securities to "secondary dealers," such as savings and loan associations, money market and mutual funds, insurance, financial, and other corporate investors. Secondary dealers, in turn, provide access to investment in the government securities to the public through a variety of mechanisms. In the context of this case, the Trusts are secondary dealers.

Given the current large national debt, vast amounts of United States government securities are issued from time to time. Repurchase agreements provide a financing function allowing dissemination of this huge quantity of debt to the investing public. Federal Reserve operations in the market on a single day through repurchase agreements frequently amount to more than $3 billion to $4 billion per day, and have reached as high as $7.9 billion in

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[9] As this Court noted in construing a predecessor to 31 U.S.C. § 3124, the purpose of the exception is to protect from state taxation "the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." *Smith v. Davis*, 323 U.S. 111, 119 (1944).

a single day. (*Id.*, Exhibit 1 to Sternlight Depo., ¶ 4, App. 3).

Sternlight concluded: "The liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets." (*Id.*, Exhibit 1 to Sternlight Depo., ¶ 3, App. 2). The underwriting function for United States Treasury issues performed by "primary dealers" would be impaired by the inability to characterize repurchase transactions as sales transactions. Impairment of the repurchase market "would make it less attractive for dealers to perform this very useful underwriting function, *thus adding to Treasury interest costs.*" (*Id.*, Exhibit 1, ¶ 6, emphasis added).

The undisputed expert testimony before the courts below clearly establishes that state taxation of repurchase transactions would "add . . . to Treasury interest costs." This Court has consistently held that such a burden on federal obligations is impermissible. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). Therefore, the Nebraska Supreme Court correctly concluded, based upon the factual record before it, that the Revenue Ruling at issue contravened the Constitution and 31 U.S.C. § 3124. There is no divergence of opinion about the meaning of federal law; the Nebraska Supreme Court simply based its decision upon a factual distinction that was not addressed in the decisions relied upon by the petitioner. This Court should not use its certiorari jurisdiction to rule in cases that simply turn upon factual differences. Therefore, the Court should deny the petitioner's request for certiorari.

II. THE DECISION OF THE NEBRASKA SUPREME COURT IS CONSISTENT WITH THIS COURT'S INTERPRETATIONS OF 31 U.S.C. § 3124.

Prior to 1959 there existed a "formal but economically meaningless distinction between taxes on Government obligations and taxes on separate interests." *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 858 (1983). In 1959 Congress amended the applicable statute and "set aside this Court's rather formalistic pre-1959 approach." *Id.* at 862. "Under the plain language of the 1959 amendment, however, the tax is barred regardless of its *form* if federal obligations must be considered, either directly or indirectly, in *computing* the tax." *Id.*

In striking down a Texas bank share taxation scheme because it failed to exclude from consideration federal obligations owned by the banks, this Court noted that the "exemption" for federal obligations is sweeping:

> [I]t "extends to *every form* of taxation that would require that either the obligations or the interest thereon, or both, *be considered, directly or indirectly, in the computation of the tax*" (emphasis supplied). *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 395-96 (the statute "establishes a broad exemption").

Id.

Under the statute, "considering" means "taken into account or included in the accounting." *Id.* The issue, therefore, is not the formal one of determining who "owns" the government obligations that are the subject of a repurchase agreement. Rather, the question is whether

taxation of the Trusts' income from purchasing and selling federal obligations subject to repurchase agreements is a form of taxation requiring either the obligations or the interest thereon or both to be considered directly or indirectly in the computation of the tax. Clearly it is and the prohibition of taxing federal obligations is therefore violated.

The Trusts in this case earn no income when they first enter into a repurchase agreement. Indeed, all that occurs is that the Trusts transfer cash to the seller and the federal obligations are transferred to a custodian for the Trusts (E2, 1, 2, Tab 2, ¶¶ 10-13). The Trusts only earn income at the conclusion of the transaction. This occurs in one of two ways. If the seller defaults and fails to repurchase the federal obligations, the Trusts sell those obligations with the intention of recovering the original purchase price plus some additional earned compensation to reflect the time value of money. At this point the Trusts would clearly have realized income requiring consideration of "either the obligations or the interest thereon, or both" which would be exempt from taxation by the State.

The other and presumably more common alternative is for the original seller to carry out its obligations and repurchase the government obligations at the agreed-upon price. (*Id.*, ¶ 18). The Trusts' profit on this resale reflects income earned by them in consideration of their holding of government obligations just as surely as the income they would receive in the first instance in the event of a default. *In either event the Trusts earn no income until they transfer the government obligations.* The economic reality is that whatever income the Trusts derive from these transactions arises in consideration of the federal

obligations that are the subject of the transaction. As a result that income must be exempt from taxation by the State of Nebraska.

CONCLUSION

For all the foregoing reasons, respondent respectfully requests that the petition for writ of certiorari be denied.

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UNITED STATES DISTRICT COURT*
FOR THE DISTRICT OF NEW JERSEY

In the Matter of: BEVILL, BRESLER & SCHULMAN ASSET MANAGEMENT CORPORATION, Debtor.	(Hon. Dickinson R. Debevoise) Civ. No. 85-1728 Chapter 11
SAUL S. COHEN, Trustee of Bevill, Bresler & Schulman Asset Management Corporation, Plaintiff, vs. ARMY MORAL SUPPORT FUND, et al., Defendants.	Adversary Proceeding No. 85-2103 Civ. No. 85-2224 Adversary Proceeding No. 85-5274
In re: BEVILL, BRESLER & SCHULMAN, INC., Debtor.	
RICHARD W. HILL, Trustee for the liquidation of Bevill, Bresler & Schulman, Inc., Plaintiff, vs. FIDELITY NEW YORK, F.A., et al., Defendants.	

*Sternlight's affidavit from the *Bevill, Bresler* bankruptcy was Exhibit 1 to his deposition which was received in evidence in this case by stipulation as an attachment to the "First Stipulation of the Parties," Exhibit 1 in the trial below.

STATE OF NEW YORK)
) ss:
COUNTY OF NEW YORK)

AFFIDAVIT OF PETER D. STERNLIGHT

1. I am Executive Vice President of the Federal Reserve Bank of New York ("FRBNY") with responsibility for the Open Market Operations Function.

2. I have had experience at the FRBNY's open market trading desk since the 1960's, and for the past six years I have been Manager of the System Open Market Account ("SOMA"). In that capacity, I have responsibility for a variety of types of transactions undertaken by the FRBNY open market desk for the account of SOMA. The object of those transactions is to adjust the level of bank reserves in order to achieve the Federal Open Market Committee's monetary policy goals. FRBNY also carries out transactions in the market on behalf of foreign central banks to aid them in their dollar investments.

3. Repurchase agreements involving United States Treasury issues and certain other agency issues are essential to the operations of the open market desk for reserve adjustments. In addition, the liquidity and flexibility provided by repurchase agreements are essential to the efficient functioning of the government securities markets. Repurchase agreements are unique vehicles for short-term, high-volume financing. As used in the market today, repurchase agreements are viewed generally as contracts for the sale of securities and their resale back to the original seller at a future date. An essential feature of this arrangement is that securities delivered under a

repurchase agreement are freely transferable and unencumbered by restriction from previous transfers.

4. During 1985, the FRBNY conducted SOMA transactions in the market in the aggregate amount of $212 billion. Of these, 74 percent were repurchase transactions, and 17 percent were reverse repurchase transactions (known to FRBNY as matched sale-purchase agreements). Thus, only 9 percent of the 1985 SOMA market transactions conducted by the FRBNY were conducted without the use of repurchase or reverse repurchase agreements. Also during 1985, the FRBNY conducted $188 billion worth of transactions in the market on behalf of approximately 150 foreign central banks and other foreign official institutions. Of these, some 62 percent were repurchase transactions. Federal Reserve operations in the market on a single day through repos or reverse repos often come to $3-4 billion and have reached as high as 7.9 billion.

5. The FRBNY repurchase transactions are, by statute, structured and conducted as contracts for purchase-and-sale. The high volume of Federal Reserve open market operations requires the broadest possible repurchase market for government securities. It is doubtful that the FRBNY would have access to a market for repurchase agreements characterized as secured loans. Such a result could impair the FRBNY's ability to maintain appropriate levels of bank reserves from week to week, diminish the FRBNY's ability to achieve reserve growth objectives, and possibly accentuate interest rate volatility.

6. Repurchase agreements are an important method for dealer financing of their inventories of United States

government securities. The primary dealers typically underwrite a sizeable portion of new Treasury issues – 35-75 percent – and rely heavily on temporary financing through repurchase agreements pending resale of the issues to other investors. Clearly, an impairment of the repo market would make it less attractive for dealers to perform this very useful underwriting function, thus adding to Treasury interest costs.

7. Repurchase agreements are a major vehicle in the market-making process, providing the means for creating hedges and arbitrages among various issues and thereby increasing liquidity. Through these transactions, the dealer market adds to the close substitutability among Treasury issues, enhancing the attractiveness of the market for a variety of participants, which in turn increases the market for Treasury issues. If repurchase agreements were to lose their present characteristics of flexibility and liquidity, the dealer market – a critical element in the process of financing the national debt through Treasury issues – would be handicapped. More generally, a hobbling of the repo market could have broad rate effects throughout the financial markets, diminishing efficiency and the allocation of resources. Market participants would turn to less liquid forms of investment that would tend to produce higher rates in the economy at large. Greater volatility of rates as a consequence of a diminished repo market could add to average rate levels.

8. Repurchase agreements have proven to be invaluable to a wide variety of institutional investors, both public and private. A significant number of participants in the market are public entities who face constitutional, statutory, or regulatory restrictions on lending and

borrowing activities, but can and do rely on repurchase agreements to achieve investment, cash management and liquidity needs. If repurchase agreements, with their present characteristics (including unencumbered transferability of securities delivered under repo contract), and in their present form and as presently understood in the market (contracts for the sale and repurchase of securities) were unavailable to these participants in the market, the more costly financing alternatives would have adverse consequences for the entities involved, and their withdrawal from the government securities market as repurchase participants would adversely impact the market.

9. Repurchase agreements, as used and understood by the FRBNY in conformity with recognized and accepted market practice, are agreements for the transfer of securities with a simultaneously executed agreement to retransfer securities back to the original seller at a specified future date. They are structured and treated as sales and repurchases, unencumbered by any restriction from prior transfer that would impede further transfer. This treatment is essential to the purposes for which repurchase agreements are employed: high-volume, short-term financing transactions.

/s/ Peter D. Sternlight
Peter D. Sternlight

Subscribed and sworn
to before me this 11th
day of April, 1986
/s/ Margaret M. Manuel
Notary Public

MARGARET M. MANUEL
Notary Public, State of New York
No. 31-4825941
Qualified in Nassau County
Certificate Filed in New York County
Commission Expires May 31, 1988